THINGS THEY DON'T TELL YOU ABOUT CAPITALISM

Ha-Joon Chang

Bestselling Author of *Bad Samaritans: The Myth of Free Trade and the Secret History of Capitalism*

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HA-JOON CHANG

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To Hee-Jeong, Yuna, and Jin-Gyu

7 Ways to Read *23 Things They Don't Tell You about Capitalism*

Way 1. If you are not even sure what capitalism is, read:
Things 1, 2, 5, 8, 13, 16, 19, 20, and 22

Way 2. If you think politics is a waste of time, read:
Things 1, 5, 7, 12, 16, 18, 19, 21, and 23

Way 3. If you have been wondering why your life does not seem to get better despite ever-rising income and ever-advancing technologies, read:
Things 2, 4, 6, 8, 9, 10, 17, 18, and 22

Way 4. If you think some people are richer than others because they are more capable, better educated and more enterprising, read:
Things 3, 10, 13, 14, 15, 16, 17, 20, and 21

Way 5. If you want to know why poor countries are poor and how they can become richer, read:
Things 3, 6, 7, 8, 9, 10, 11, 12, 15, 17, and 23

Way 6. If you think the world is an unfair place but there is nothing much you can do about it, read:
Things 1, 2, 3, 4, 5, 11, 13, 14, 15, 20, and 21

Way 7. Read the whole thing in the following order . . .

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Introduction

The global economy lies in tatters. While fiscal and monetary stimulus of unprecedented scale has prevented the financial melt-down of 2008 from turning into a total collapse of the global economy, the 2008 global crash still remains the second-largest economic crisis in history, after the Great Depression. At the time of writing (March 2010), even as some people declare the end of the recession, a sustained recovery is by no means certain. In the absence of financial reforms, loose monetary and fiscal policies have led to new financial bubbles, while the real economy is starved of money. If these bubbles burst, the global economy could fall into another ('double-dip') recession. Even if the recovery is sustained, the aftermath of the crisis will be felt for years. It may be several years before the corporate and the household sectors rebuild their balance sheets. The huge budget deficits created by the crisis will force governments to reduce public investments and welfare entitlements significantly, negatively affecting economic growth, poverty and social stability – possibly for decades. Some of those who lost their jobs and houses during the crisis may never join the economic mainstream again. These are frightening prospects.

This catastrophe has ultimately been created by the free-market ideology that has ruled the world since the 1980s. We have been told that, if left alone, markets will produce the most efficient and just outcome. Efficient, because individuals know best how to utilize the resources they command, and just, because the competitive market process ensures that individuals are rewarded according to their productivity. We have been told that business should be given maximum freedom. Firms, being closest to the market, know what is best for their businesses. If we let them do what they want, wealth creation will be maximized, benefiting the rest of society as well. We were told that government intervention in the markets would only reduce their efficiency. Government intervention is often designed to limit the very scope of wealth creation for misguided egalitarian reasons. Even when it is not, governments cannot improve on market outcomes, as they have neither the necessary information nor the incentives to make good business decisions. In sum, we were told to put all our trust in the market and get out of its way.

Following this advice, most countries have introduced free-market policies over the last three decades – privatization of state-owned industrial and financial firms, deregulation of finance and industry, liberalization of international trade and investment, and reduction in income taxes and welfare payments. These policies, their advocates admitted, may temporarily create some problems, such as rising inequality, but ultimately they will make everyone better off by creating a more dynamic and wealthier society. The rising tide lifts all boats together, was the metaphor.

The result of these policies has been the polar opposite of what was promised. Forget for a moment the financial meltdown, which will scar the world for decades to come. Prior to that, and unbeknown to most people, free-market policies had resulted in slower growth, rising inequality and heightened instability in most countries. In many rich countries, these problems were masked by huge credit expansion; thus the fact that US wages had remained stagnant and working hours increased since the 1970s was conveniently fogged over by the heady brew of credit-fuelled consumer boom. The problems were bad enough in the rich countries, but they were even more serious for the developing world. Living standards in Sub-Saharan Africa have stagnated for the last three decades, while Latin America has seen its per capita growth rate fall by two-thirds during the period. There were some developing countries that grew fast (although with rapidly rising inequality) during this period, such as China and India, but these are precisely the countries that, while partially liberalizing, have refused to introduce full-blown free-market policies.

Thus, what we were told by the free-marketeers – or, as they are often called, neo-liberal economists – was at best only partially true and at worst plain wrong. As I will show throughout this book, the 'truths' peddled by free-market ideologues are based on lazy assumptions and blinkered visions, if not necessarily self-serving notions. My aim in this book is to tell you some essential truths about capitalism that the free-marketeers won't.

This book is not an anti-capitalist manifesto. Being critical of free-market ideology is not the same as being against capitalism. Despite its problems and limitations, I believe that capitalism is still the best economic system that humanity has invented. My criticism is of a particular version of capitalism that has dominated the world in the last three decades, that is, free-market capitalism. This is not the only way to run capitalism, and certainly not the best, as the record of the last three decades shows. The book shows that there are ways in which capitalism should, and can, be made better.

Even though the 2008 crisis has made us seriously question the way in which our economies are run, most of us do not pursue such questions because we think that they are ones for the experts. Indeed they are – at one level. The precise answers do require knowledge on many technical issues, many of them so complicated that the experts themselves disagree on them. It is then natural that most of us simply do not have the time or the necessary training to learn all the technical details before we can pronounce our judgements on the effectiveness of TARP (Troubled Asset Relief Program), the necessity of G20, the wisdom of bank nationalization or the appropriate levels of executive salaries. And when it comes to things like poverty in Africa, the workings of the World Trade Organization, or the capital adequacy rules of the Bank for International Settlements, most of us are frankly lost.

However, it is *not* necessary for us to understand all the technical details in order to understand what is going on in the world and exercise what I call an 'active economic citizenship' to demand the right courses of action from those in decision-making positions. After all, we make judgements about all sorts of other issues despite lacking technical expertise. We don't need to be expert epidemiologists in order to know that there should be hygiene standards in food factories, butchers and restaurants. Making judgements about economics is no different: once you know the key principles and basic facts, you can make some robust judgements without knowing the technical details. The only prerequisite is that you are willing to remove those rose-tinted glasses that neo-liberal ideologies like you to wear every day. The glasses make the world look simple and pretty. But lift them off and stare at the clear harsh light of reality.

Once you know that there is really no such thing as a free market, you won't be deceived by people who denounce a regulation on the grounds that it makes the market 'unfree' (*see Thing 1*). When you learn that large and active governments can promote, rather than dampen, economic dynamism, you will see that the widespread distrust of government is unwarranted (*see Things 12 and 21*). Knowing that we do *not* live in a post-industrial knowledge economy will make you question the wisdom of neglecting, or even implicitly welcoming, industrial decline of a country, as some governments have done (*see Things 9 and 17*). Once you realize that trickle-down economics does not work, you will see the excessive tax cuts for the rich for what they are – a simple upward redistribution of income, rather than a way to make all of us richer, as we were told (*see Things 13 and 20*).

What has happened to the world economy was no accident or the outcome of an irresistible force of history. It is not because of some iron law of the market that wages have been stagnating and working hours rising for most Americans, while the top managers and bankers vastly increased their incomes (*see Things 10 and 14*). It is not simply because of unstoppable progress in the technologies of communications and transportation that we are exposed to increasing forces of international competition and have to worry about job security (*see Things 4 and 6*). It was not inevitable that the financial sector got more and more detached from the real economy in the last three decades, ultimately creating the economic catastrophe we are in today (*see Things 18 and 22*). It is not mainly because of some unalterable structural factors – tropical climate, unfortunate location, or bad culture – that poor countries are poor (*see Things 7 and 11*).

Human decisions, especially decisions by those who have the power to set the rules, make things happen in the way they happen, as I will explain. Even though no single decision-maker can be sure that her actions will always lead to the desired results, the decisions that have been made are not in some sense inevitable. We do not live in the best of all possible worlds. If different decisions had been taken, the world would have been a different place. Given this, we need to ask whether the decisions that the rich and the powerful take are based on sound reasoning and robust evidence. Only when we do that can we demand right actions from corporations, governments and international organizations. Without our active economic citizenship, we will always be the victims of people who have greater ability to make decisions, who tell us that things happen because they have to and therefore that there is nothing we can do to alter them, however unpleasant and unjust they may appear.

This book is intended to equip the reader with an understanding of how capitalism really works and how it can be made to work better. It is, however, not an 'economics for dummies'. It is attempting to be both far less and far more.

It is less than economics for dummies because I do not go into many of the technical details that even a basic introductory book on economics would be compelled to explain. However, this neglect of technical details is not because I believe them to be beyond my readers. 95 per cent of economics is common sense made complicated, and even for the remaining 5 per cent, the essential reasoning, if not all the technical details, can be explained in plain terms. It is simply because I believe that the best way to learn economic principles is by using them to understand problems that interest the reader the most. Therefore, I introduce technical details only when they become relevant, rather than in a systematic, textbook-like manner.

But while completely accessible to non-specialist readers, this book is a lot more than economics for dummies. Indeed, it goes much deeper than many advanced economics books in the sense that it questions many received economic theories and empirical facts that those books take for granted. While it may sound daunting for a non-specialist reader to be asked to question theories that are supported by the 'experts' and to suspect empirical facts that are accepted by most professionals in the field, you will find that this is actually a lot easier than it sounds, once you stop assuming that what most experts believe must be right.

Most of the issues I discuss in the book do not have simple answers. Indeed, in many cases, my main point is that there is no simple answer, unlike what free-market economists want you to believe. However, unless we confront these issues, we will not perceive how the world really works. And unless we understand that, we won't be able to defend our own interests, not to speak of doing greater good as active economic citizens.

Thing 1
There is no such thing as a free market

What they tell you

Markets need to be free. When the government interferes to dictate what market participants can or cannot do, resources cannot flow to their most efficient use. If people cannot do the things that they find most profitable, they lose the incentive to invest and innovate. Thus, if the government puts a cap on house rents, landlords lose the incentive to maintain their properties or build new ones. Or, if the government restricts the kinds of financial products that can be sold, two contracting parties that may both have benefited from innovative transactions that fulfil their idiosyncratic needs cannot reap the potential gains of free contract. People must be left 'free to choose', as the title of free-market visionary Milton Friedman's famous book goes.

What they don't tell you

The free market doesn't exist. Every market has some rules and boundaries that restrict freedom of choice. A market looks free only because we so unconditionally accept its underlying restrictions that we fail to see them. How 'free' a market is cannot be objectively defined. It is a political definition. The usual claim by free-market economists that they are trying to defend the market from politically motivated interference by the government is false. Government is always involved and those free-marketeers are as politically motivated as anyone. Overcoming the myth that there is such a thing as an objectively defined 'free market' is the first step towards understanding capitalism.

Labour ought to be free

In 1819 new legislation to regulate child labour, the Cotton Factories Regulation Act, was tabled in the British Parliament. The proposed regulation was incredibly 'light touch' by modern standards. It would ban the employment of young children – that is, those under the age of nine. Older children (aged between ten and sixteen) would still be allowed to work, but with their working hours restricted to twelve per day (yes, they were really going soft on those kids). The new rules applied only to cotton factories, which were recognized to be exceptionally hazardous to workers' health.

The proposal caused huge controversy. Opponents saw it as undermining the sanctity of freedom of contract and thus destroying the very foundation of the free market. In debating this legislation, some members of the House of Lords objected to it on the grounds that 'labour ought to be free'. Their argument said: the children want (and need) to work, and the factory owners want to employ them; what is the problem?

Today, even the most ardent free-market proponents in Britain or other rich countries would not think of bringing child labour back as part of the market liberalization package that they so want. However, until the late nineteenth or the early twentieth century, when the first serious child labour regulations were introduced in Europe and North America, many respectable people judged child labour regulation to be against the principles of the free market.

Thus seen, the 'freedom' of a market is, like beauty, in the eyes of the beholder. If you believe that the right of children not to have to work is more important than the right of factory owners to be able to hire whoever they find most profitable, you will not see a ban on child labour as an infringement on the freedom of the labour market. If you believe the opposite, you will see an 'unfree' market, shackled by a misguided government regulation.

We don't have to go back two centuries to see regulations we take for granted (and accept as the 'ambient noise' within the free market) that were seriously challenged as undermining the free market, when first introduced. When environmental regulations (e.g., regulations on car and factory emissions) appeared a few decades ago, they were opposed by many as serious infringements on our freedom to choose. Their opponents asked: if people want to drive in more polluting cars or if factories find more polluting production methods more profitable, why should the government prevent them from making such choices? Today, most people accept these regulations as 'natural'. They believe that actions that harm others, however unintentionally (such as pollution), need to be restricted. They also understand that it is sensible to make careful use of our energy resources, when many of them are non-renewable. They may believe that reducing human impact on climate change makes sense too.

If the same market can be perceived to have varying degrees of freedom by different people, there is really no objective way to define how free that market is. In other words, the free market is an illusion. If some markets *look* free, it is only because we so totally accept the regulations that are propping them up that they become invisible.

Piano wires and kungfu masters

Like many people, as a child I was fascinated by all those gravity-defying kungfu masters in Hong Kong movies. Like many kids, I suspect, I was bitterly disappointed when I learned that those masters were actually hanging on piano wires.

The free market is a bit like that. We accept the legitimacy of certain regulations so totally that we don't see them. More carefully examined, markets are revealed to be propped up by rules – and many of them.

To begin with, there is a huge range of restrictions on what can be traded; and not just bans on 'obvious' things such as narcotic drugs or human organs. Electoral votes, government jobs and legal decisions are not for sale, at least openly, in modern economies, although they were in most countries in the past. University places may not usually be sold, although in some nations money can buy them – either through (illegally) paying the selectors or (legally) donating money to the university. Many countries ban trading in firearms or alcohol. Usually medicines have to be explicitly licensed by the government, upon the proof of their safety, before they can be marketed. All these regulations are potentially controversial – just as the ban on selling human beings (the slave trade) was one and a half centuries ago.

There are also restrictions on who can participate in markets. Child labour regulation now bans the entry of children into the labour market. Licences are required for professions that have significant impacts on human life, such as medical doctors or lawyers (which may sometimes be issued by professional associations rather than by the government). Many countries allow only companies with more than a certain amount of capital to set up banks. Even the stock market, whose under-regulation has been a cause of the 2008 global recession, has regulations on who can trade. You can't just turn up in the New York Stock Exchange (NYSE) with a bag of shares and sell them. Companies must fulfil listing requirements, meeting stringent auditing standards over a certain number of years, before they can offer their shares for trading. Trading of shares is only conducted by licensed brokers and traders.

Conditions of trade are specified too. One of the things that surprised me when I first moved to Britain in the mid 1980s was that one could demand a full refund for a product one didn't like, even if it wasn't faulty. At the time, you just couldn't do that in Korea, except in the most exclusive department stores. In Britain, the consumer's right to change her mind was considered more important than the right of the seller to avoid the cost involved in returning unwanted (yet functional) products to the manufacturer. There are many other rules regulating various aspects of the exchange process: product liability, failure in delivery, loan default, and so on. In many countries, there are also necessary permissions for the location of sales outlets – such as restrictions on street-vending or zoning laws that ban commercial activities in residential areas.

Then there are price regulations. I am not talking here just about those highly visible phenomena such as rent controls or minimum wages that free-market economists love to hate.

Wages in rich countries are determined more by immigration control than anything else, including any minimum wage legislation. How is the immigration maximum determined? Not by the 'free' labour market, which, if left alone, will end up replacing 80–90 per cent of native workers with cheaper, and often more productive, immigrants. Immigration is largely settled by politics. So, if you have any residual doubt about the massive role that the government plays in the economy's free market, then pause to reflect that all our wages are, at root, politically determined (*see Thing 3*).

Following the 2008 financial crisis, the prices of loans (if you can get one or if you already have a variable rate loan) have become a lot lower in many countries thanks to the continuous slashing of interest rates. Was that because suddenly people didn't want loans and the banks needed to lower their prices to shift them? No, it was the result of political decisions to boost demand by cutting interest rates. Even in normal times, interest rates are set in most countries by the central bank, which means that political considerations creep in. In other words, interest rates are also determined by politics.

If wages and interest rates are (to a significant extent) politically determined, then all the other prices are politically determined, as they affect all other prices.

Is free trade fair?

We see a regulation when we don't endorse the moral values behind it. The nineteenth-century high-tariff restriction on free trade by the US federal government outraged slave-owners, who at the same time saw nothing wrong with trading people in a free market. To those who believed that people can be owned, banning trade in slaves was objectionable in the same way as restricting trade in manufactured goods. Korean shopkeepers of the 1980s would probably have thought the requirement for 'unconditional return' to be an unfairly burdensome government regulation restricting market freedom.

This clash of values also lies behind the contemporary debate on free trade vs. fair trade. Many Americans believe that China is engaged in international trade that may be free but is not fair. In their view, by paying workers unacceptably low wages and making them work in inhumane conditions, China competes unfairly. The Chinese, in turn, can riposte that it is unacceptable that rich countries, while advocating free trade, try to impose artificial barriers to China's exports by attempting to restrict the import of 'sweatshop' products. They find it unjust to be prevented from exploiting the only resource they have in greatest abundance – cheap labour.

Of course, the difficulty here is that there is no objective way to define 'unacceptably low wages' or 'inhumane working conditions'. With the huge international gaps that exist in the level of economic development and living standards, it is natural that what is a starvation wage in the US is a handsome wage in China (the average being 10 per cent that of the US) and a fortune in India (the average being 2 per cent that of the US). Indeed, most fair-trade-minded Americans would not have bought things made by their own grandfathers, who worked extremely long hours under inhumane conditions. Until the beginning of the twentieth century, the average work week in the US was around sixty hours. At the time (in 1905, to be more precise), it was a country in which the Supreme Court declared unconstitutional a New York state law limiting the working days of bakers to ten hours, on the grounds that it 'deprived the baker of the liberty of working as long as he wished'.

Thus seen, the debate about fair trade is essentially about moral values and political decisions, and not economics in the usual sense. Even though it is about an economic issue, it is not something economists with their technical tool kits are particularly well equipped to rule on.

All this does *not* mean that we need to take a relativist position and fail to criticize anyone because anything goes. We can (and I do) have a view on the acceptability of prevailing labour standards in China (or any other country, for that matter) and try to do something about it, without believing that those who have a different view are wrong in some absolute sense. Even though China cannot afford American wages or Swedish working conditions, it certainly can improve the wages and the working conditions of its workers. Indeed, many Chinese don't accept the prevailing conditions and demand tougher regulations. But economic theory (at least free-market economics) cannot tell us what the 'right' wages and working conditions should be in China.

I don't think we are in France any more

In July 2008, with the country's financial system in meltdown, the US government poured $200 billion into Fannie Mae and Freddie Mac, the mortgage lenders, and nationalized them. On witnessing this, the Republican Senator Jim Bunning of Kentucky famously denounced the action as something that could only happen in a 'socialist' country like France.

France was bad enough, but on 19 September 2008, Senator Bunning's beloved country was turned into the Evil Empire itself by his own party leader. According to the plan announced that day by President George W. Bush and subsequently named TARP (Troubled Asset Relief Program), the US government was to use at least $700 billion of taxpayers' money to buy up the 'toxic assets' choking up the financial system.

President Bush, however, did not see things quite that way. He argued that, rather than being 'socialist', the plan was simply a continuation of the American system of free enterprise, which 'rests on the conviction that the federal government should interfere in the market place only when necessary'. Only that, in his view, nationalizing a huge chunk of the financial sector was just one of those necessary things.

Mr Bush's statement is, of course, an ultimate example of political double-speak – one of the biggest state interventions in human history is dressed up as another workaday market process. However, through these words Mr Bush exposed the flimsy foundation on which the myth of the free market stands. As the statement so clearly reveals, what is a necessary state intervention consistent with free-market capitalism is really a matter of opinion. There is no scientifically defined boundary for free market.

If there is nothing sacred about any particular market boundaries that happen to exist, an attempt to change them is as legitimate as the attempt to defend them. Indeed, the history of capitalism has been a constant struggle over the boundaries of the market.

A lot of the things that are outside the market today have been removed by political decision, rather than the market process itself – human beings, government jobs, electoral votes, legal decisions, university places or uncertified medicines. There are still attempts to buy at least some of these things illegally (bribing government officials, judges or voters) or legally (using expensive lawyers to win a lawsuit, donations to political parties, etc.), but, even though there have been movements in both directions, the trend has been towards less marketization.

For goods that are still traded, more regulations have been introduced over time. Compared even to a few decades ago, now we have much more stringent regulations on who can produce what (e.g., certificates for organic or fair-trade producers), how they can be produced (e.g., restrictions on pollution or carbon emissions), and how they can be sold (e.g., rules on product labelling and on refunds).

Furthermore, reflecting its political nature, the process of re-drawing the boundaries of the market has sometimes been marked by violent conflicts. The Americans fought a civil war over free trade in slaves (although free trade in goods – or the tariffs issue – was also an important issue).[1] The British government fought the Opium War against China to realize a free trade in opium. Regulations on free market in child labour were implemented only because of the struggles by social reformers, as I discussed earlier. Making free markets in government jobs or votes illegal has been met with stiff resistance by political parties who bought votes and dished out government jobs to reward loyalists. These practices came to an end only through a combination of political activism, electoral reforms and changes in the rules regarding government hiring.

Recognizing that the boundaries of the market are ambiguous and cannot be determined in an objective way lets us realize that economics is not a science like physics or chemistry, but a political exercise. Free-market economists may want you to believe that the correct boundaries of the market can be scientifically determined, but this is incorrect. If the boundaries of what you are studying cannot be scientifically determined, what you are doing is not a science.

Thus seen, opposing a new regulation is saying that the status quo, however unjust from some people's point of view, should not be changed. Saying that an existing regulation should be abolished is saying that the domain of the market should be expanded, which means that those who have money should be given more power in that area, as the market is run on one-dollar-one-vote principle.

So, when free-market economists say that a certain regulation should not be introduced because it would restrict the 'freedom' of a certain market, they are merely expressing a political opinion that they reject the rights that are to be defended by the proposed law. Their ideological cloak is to pretend that their politics is not really political, but rather is an objective economic truth, while other people's politics *is* political. However, they are as politically motivated as their opponents.

Breaking away from the illusion of market objectivity is the first step towards understanding capitalism.

Thing 2
Companies should *not* be run in the interest of their owners

What they tell you

Shareholders own companies. Therefore, companies should be run in their interests. It is not simply a moral argument. The shareholders are not guaranteed any fixed payments, unlike the employees (who have fixed wages), the suppliers (who are paid specific prices), the lending banks (who get paid fixed interest rates), and others involved in the business. Shareholders' incomes vary according to the company's performance, giving them the greatest incentive to ensure the company performs well. If the company goes bankrupt, the shareholders lose everything, whereas other 'stakeholders' get at least something. Thus, shareholders bear the risk that others involved in the company do not, incentivizing them to maximize company performance. When you run a company for the shareholders, its profit (what is left after making all fixed payments) is maximized, which also maximizes its social contribution.

What they don't tell you

Shareholders may be the owners of corporations but, as the most mobile of the 'stakeholders', they often care the least about the long-term future of the company (unless they are so big that they cannot really sell their shares without seriously disrupting the business). Consequently, shareholders, especially but not exclusively the smaller ones, prefer corporate strategies that maximize short-term profits, usually at the cost of long-term investments, and maximize the dividends from those profits, which even further weakens the long-term prospects of the company by reducing the amount of retained profit that can be used for re-investment. Running the company for the shareholders often reduces its long-term growth potential.

Karl Marx defends capitalism

You have probably noticed that many company names in the English-speaking world come with the letter L – PLC, LLC, Ltd, etc. The letter L in these acronyms stands for 'limited', short for 'limited liability' – public *limited* company (PLC), *limited* liability company (LLC) or simply *limited* company (Ltd). Limited liability means that investors in the company will lose only what they have invested (their 'shares'), should it go bankrupt.

However, you may not have realized that the L word, that is, limited liability, is what has made modern capitalism possible. Today, this form of organizing a business enterprise is taken for granted, but it wasn't always like that.

Before the invention of the limited liability company in sixteenth-century Europe – or the joint-stock company, as it was known in its early days – businessmen had to risk everything when they started a venture. When I say everything, I really mean everything – not just personal property (unlimited liability meant that a failed businessman had to sell all his personal properties to repay all the debts) but also personal freedom (they could go to a debtors' prison, should they fail to honour their debts). Given this, it is almost a miracle that anyone was willing to start a business at all.

Unfortunately, even after the invention of limited liability, it was in practice very difficult to use it until the mid nineteenth century – you needed a royal charter in order to set up a limited liability company (or a government charter in a republic). It was believed that those who were managing a limited liability company without owning it 100 per cent would take excessive risks, because part of the money they were risking was not their own. At the same time, the non-managing investors in a limited liability company would also become less vigilant in monitoring the managers, as their risks were capped (at their respective investments). Adam Smith, the father of economics and the patron saint of free-market capitalism, opposed limited liability on these grounds. He famously said that the 'directors of [joint stock] companies . . . being the managers rather of other people's money than of their own, it cannot well be expected that they would watch over it with the same anxious vigilance with which the partners in a private copartnery [i.e., partnership, which demands unlimited liability] frequently watch over their own'.[1]

Therefore, countries typically granted limited liability only to exceptionally large and risky ventures that were deemed to be of national interest, such as the Dutch East India Company set up in 1602 (and its arch-rival, the British East India Company) and the notorious South Sea Company of Britain, the speculative bubble surrounding which in 1721 gave limited liability companies a bad name for generations.

By the mid nineteenth century, however, with the emergence of large-scale industries such as railways, steel and chemicals, the need for limited liability was felt increasingly acutely. Very few people had a big enough fortune to start a steel mill or a railway singlehandedly, so, beginning with Sweden in 1844 and followed by Britain in 1856, the countries of Western Europe and North America made limited liability generally available – mostly in the 1860s and 70s.

However, the suspicion about limited liability lingered on. Even as late as the late nineteenth century, a few decades after the introduction of generalized limited liability, small businessmen in Britain 'who, being actively in charge of a business as well as its owner, sought to limit responsibility for its debts by the device of incorporation [limited liability]' were frowned upon, according to an influential history of Western European entrepreneurship.[2]

Interestingly, one of the first people who realized the significance of limited liability for the development of capitalism was Karl Marx, the supposed arch-enemy of capitalism. Unlike many of his contemporary free-market advocates (and Adam Smith before them), who opposed limited liability, Marx understood how it would enable the mobilization of large sums of capital that were needed for the newly emerging heavy and chemical industries by reducing the risk for individual investors. Writing in 1865, when the stock market was still very much a side-show in the capitalist drama, Marx had the foresight to call the joint-stock company 'capitalist production in its highest development'. Like his free-market opponents, Marx was aware of, and criticized, the tendency for limited liability to encourage excessive risk-taking by managers. However, Marx considered it to be a side-effect of the huge material progress that this institutional innovation was about to bring. Of course, in defending the 'new' capitalism against its free-market critics, Marx had an ulterior motive. He thought the joint-stock company was a 'point of transition' to socialism in that it separated ownership from management, thereby making it possible to eliminate capitalists (who now do not manage the firm) without jeopardizing the material progress that capitalism had achieved.

The death of the capitalist class

Marx's prediction that a new capitalism based on joint-stock companies would pave the way for socialism has not come true. However, his prediction that the new institution of generalized limited liability would put the productive forces of capitalism on to a new plane proved extremely prescient.

During the late nineteenth and early twentieth centuries limited liability hugely accelerated capital accumulation and technological progress. Capitalism was transformed from a system made up of Adam Smith's pin factories, butchers and bakers, with at most dozens of employees and managed by a sole owner, into a system of huge corporations hiring hundreds or even thousands of employees, including the top managers themselves, with complex organizational structures.

Initially, the long-feared managerial incentive problem of limited liability companies – that the managers, playing with other people's money, would take excessive risk – did not seem to matter very much. In the early days of limited liability, many large firms were managed by a charismatic entrepreneur – such as Henry Ford, Thomas Edison or Andrew Carnegie – who owned a significant chunk of the company. Even though these part-owner-managers could abuse their position and take excessive risk (which they often did), there was a limit to that. Owning a large chunk of the company, they were going to hurt themselves if they made an overly risky decision. Moreover, many of these part-owner-managers were men of exceptional ability and vision, so even their poorly incentivized decisions were often superior to those made by most of those well-incentivized full-owner-managers.

However, as time wore on, a new class of professional managers emerged to replace these charismatic entrepreneurs. As companies grew in size, it became more and more difficult for anyone to own a significant share of them, although in some European countries, such as Sweden, the founding families (or foundations owned by them) hung on as the dominant shareholders, thanks to the legal allowance to issue new shares with smaller (typically 10 per cent, sometimes even 0.1 per cent) voting rights. With these changes, professional managers became the dominant players and the shareholders became increasingly passive in determining the way in which companies were run.

From the 1930s, the talk was increasingly of the birth of managerial capitalism, where capitalists in the traditional sense – the 'captains of industry', as the Victorians used to call them – had been replaced by career bureaucrats (private sector bureaucrats, but bureaucrats nonetheless). There was an increasing worry that these hired managers were running the enterprises in their own interests, rather than in the interests of their legal owners, that is, the shareholders. When they should be maximizing profits, it was argued, these managers were maximizing sales (to maximize the size of the company and thus their own prestige) and their own perks, or, worse, engaged directly in prestige projects that add hugely to their egos but little to company profits and thus its value (measured essentially by its stock market capitalization).

Some accepted the rise of the professional managers as an inevitable, if not totally welcome, phenomenon. Joseph Schumpeter, the Austrian-born American economist who is famous for his theory of entrepreneurship (*see Thing 15*), argued in the 1940s that, with the growing scale of companies and the introduction of scientific principles in corporate research and development, the heroic entrepreneurs of early capitalism would be replaced by bureaucratic professional managers. Schumpeter believed this would reduce the dynamism of capitalism, but thought it inevitable. Writing in the 1950s, John Kenneth Galbraith, the Canadian-born American economist, also argued that the rise of large corporations managed by professional managers was unavoidable and therefore that the only way to provide 'countervailing forces' to those enterprises was through increased government regulation and enhanced union power.

However, for decades after that, more pure-blooded advocates of private property have believed that managerial incentives need to be designed in such a way that the managers maximize profits. Many fine brains had worked on this 'incentive design' problem, but the 'holy grail' proved elusive. Managers could always find a way to observe the letter of the contract but not the spirit, especially when it is not easy for shareholders to verify whether poor profit performance by a manager was the result of his failure to pay enough attention to profit figures or due to forces beyond his control.

The holy grail or an unholy alliance?

And then, in the 1980s, the holy grail was found. It was called the principle of shareholder value maximization. It was argued that professional managers should be rewarded according to the amount they can give to shareholders. In order to achieve this, it was argued, first profits need to be maximized by ruthlessly cutting costs – wage bills, investments, inventories, middle-level managers, and so on. Second, the highest possible share of these profits needs to be distributed to the shareholders – through dividends and share buybacks. In order to encourage managers to behave in this way, the proportion of their compensation packages that stock options account for needs to be increased, so that they identify more with the interests of the shareholders.